# Banks create money, fintechs don't

**Steve Keen**

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**Interview with https://www.altfi.com/**

**A news, views and events company for the rapidly growing alternative finance, digital banking and robo-advice sectors.**

**AltFi: Most people think money is created when central banks print it. But you say that most money is created by private banks - Barclays, Bank of America, Commonwealth Bank etc.?**

Steve Keen: It's double entry book keeping.

Central banks do create money. The government Treasury has an account at the central bank and they sell bonds to the central bank. The central bank then pays the Treasury and records its bonds as an asset. That creates money. This is the only mechanism most people know. So the government can create money by spending more than it takes in taxation and financing the difference with central bank purchased bonds.

But private banks also use double entry bookkeeping.

Let's say you want to go buy a house in Melbourne, the bank says "here's $5 million dollars", which you then transfer to the account of the person you've bought it from. The bank then records that they've got a $5 million asset: the debt you owe to them. The bank also records that it has a debt: the money paid to the seller of the house. So double entry bookkeeping allows the bank to expand its assets and liabilities equally. To profit banks have an incentive to make as much debt as they can, as your debt is their asset.

My favourite proof of this was the service station owner in New Zealand who applied for an overdraft. A Chinese national applied for a Westpac overdraft of $100,000. It was approved. He went to check his account the next day and found he'd been given a $10 million overdraft. The clerk had made a mistake: not pressing a decimal point (or the keyboard jammed). The bank's keyboard created the money.

**Then what happens to the hard working school teachers and nurses who deposit money in the banks? Aren't savers' deposits getting lent out?**

No. Not at all. Deposits don't create loans; loans create deposits.

This is something that has been argued for 50 years by rebel economists like myself, starting with Basil Moore who made the first empirical arguments back in the 1970s. But finally central banks that know what they're talking about - and this does not include the Reserve Bank of Australia who are a bunch of economic morons in my opinion - but banks like the Bank of England and the Bundesbank are coming out and saying loans create deposits.

We use our bank accounts as transaction accounts. When you get paid your salary, you whack it into a deposit account at the bank. You can then shop with that money and transfer money from one account to another. But the level of loans is a decision from the bank. The money that is circulating is partly transactional money, partly loan money.

So money is the turnover of transactional money and the turnover of new debt.

**Some people say this isn't money that's being created, it's just transferrable bank debt.**

People are always asking 'what is money?'. Some people think it should be gold or a commodity or something else. But money has always been trust — however its manifest. So in that sense we trust the banks. If you give me a piece of A4 paper saying, "Steve Keen I owe you $100", I might accept that for you to buy something off me for now, but you're going to have to pay me back in cash at some point. But if you send me that exact same note with a bank signature on it you don't have to pay me back with cash.

People can have all sorts of arguments about what money should be. But money, in practice, is bank liabilities. We accept the transfer of bank liabilities between ourselves as money.

**Some fintech companies want to displace banks. They believe that banks make loans inefficiently and price them unfairly. But do fintechs create money?**

They're kind of like building societies.

The reason that banks can create money is that they're authorised to have deposit accounts. And they're allowed to expand the asset side of their ledger - i.e. the loans - at the same time as the liabilities side - the deposits.

But if you're a building society, which is what a lot of these fintech companies are like, then you have an account yourself at a bank. When these types of companies make loans, their reservoir falls by the amount lent out. Their assets don't expand with the transfer of money. If they lend something to someone they have an asset that falls an equivalent amount to the value of the loan.

Fintech is peer-to-peer. That is the model that most people (mistakenly) think of banks as having.

**Is it unrealistic to expect peer-to-peer lenders to eat banks' lunches when banks can create money but peer-to-peer lenders can't?**

Yeah, it's unrealistic because there has never been a capitalist economy that has grown without a growing money supply. The only way fintech could support an expanding physical level of output is if prices fall. But because we live in a debt-based system if prices fall then the revenue servicing your debt will also fall, stopping you covering your debts. You'll end up with debt deflation.

So fintechs are not a system for expanding the money supply; they're a system for distributing the money supply. The loans they make don't add to aggregate demand. For someone to make a fintech loan, they have to give up money they could otherwise be spending. Whereas banks, because they create money, can expand aggregate demand and incomes. Fintech companies are not capable of that.

**Banks are obviously very powerful politically despite the fact that - at least in Australia from the polls I've seen - they don't have much public sympathy.**

It's because the growth of the financial sector has been so enormous. But it's a cyclical thing.

My father was a banker and worked back in the days when the Commonwealth Bank of Australia was a combined private banking institution and also a central bank. He got the choice of going one way or the other and dad decided to go with private banking. He used to say back in the early days if the governors in the central bank told the bosses of the other private banks to jump out the window they'd ask "which floor?" But 20 years later he said the private banks would be telling the reserve bank governors which floor to jump out of.

The political power of banks is directly related to the level of debt in society. And because they can create money they effectively have an unlimited power to lobby. What you find is the major lobbyists in Washington are bank lobbyists. When you look at the scale of the financial sector, it is so far removed from the days of the Great Depression and all the memories of what banking led to back then, that politicians themselves cannot imagine capitalism without a large financial sector.

When the GFC came along they couldn't imagine letting the financial sector go. They never said: "you guys screwed up, we're going to nationalise your assets because you're bankrupt and put you in receivership, and then re-organise and resell you at a later stage, and your major employees that don't go behind bars for fraud will have to find another job". That's what happened in the 1930s and something similar happened in the Savings and Loans Crisis. So if you talk to William K. Black, who was the chief investigator for the S&L crisis, he reckons he put around 300 people behind bars. Only one person went to jail from the GFC.

**You've called in the past for a debt jubilee. That's something people in finance can laugh about. What would you say to convince them?**

You've got to make it something that's a negative for them. One of the implications of a debt jubilee is that financial services should be about one-third of the current size that it is. Looking at the historical record, the level debt of a country like the US actually needs is something between 25 and 75 percent of GDP. The current level of debt in the US is 150 percent of GDP.

If you're going to have a jubilee the ultimate effect will be a reduction of the financial sector to about half or a third of its current size. They're not going to love me for that.

But the other method we used to achieve that result was World War II. Socially, a jubilee is slightly cheaper than a world war.

We did it in WWII because there was an existential threat. Massive government creation of money financed WWII. That meant there wasn't much to spend on and you were being paid by the government to produce weapons. It also meant that companies didn't need to borrow money: they could just get paid by the government. That drastically reduced the levels of private debt and helped create the booms in the 1950s and 1960s.

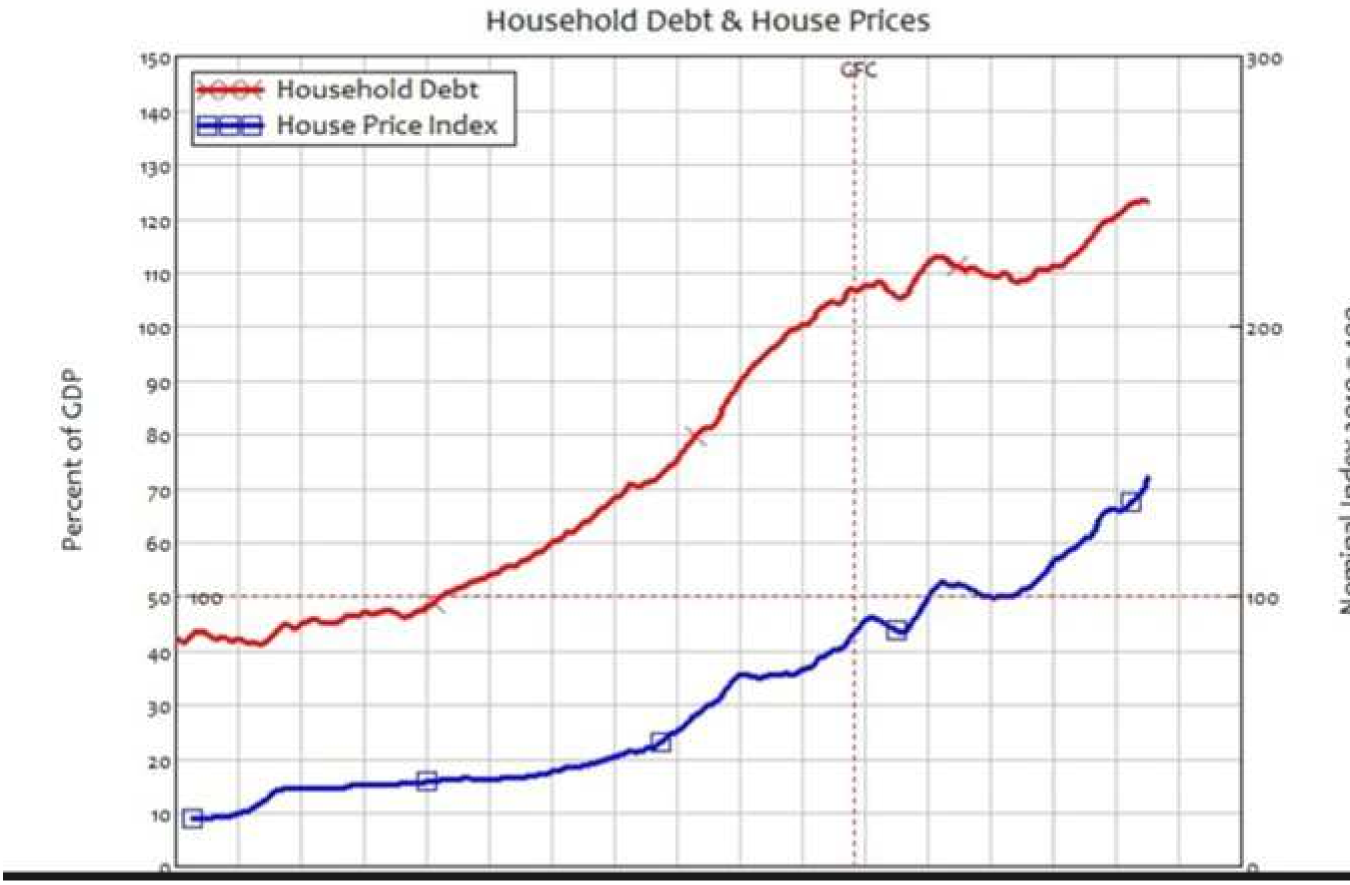
It was an existential threat that helped us turn around the great depression. I think the next existential threat that will help us turn things around will be climate change. Just like no-one in the UK complained about the size of the deficit in 1940, no-one said, "we can't afford that spitfire". Britain's deficit in 1940 was 40 percent of GDP.

**Do you still think Australia is in a property bubble?**

Yes. Absolutely it's in a property bubble. The source of housing bubbles is people using borrowed money to raise prices.

If you look globally, to have rising house prices you have to have accelerating mortgage debt. Now, of course, nothing can accelerate forever. You have three things to look at: level of debt compared to GDP; the rate of change of that debt; the rate of change of that rate of change.

# Household Debt and House Prices




(*Graph correlating Australian house prices and household debt. Source: Steve Keen)*

Now rising house prices require the rate of change to be getting faster. That implies for that to continue happening you reach infinite debt levels. But that can’t happen. Australia now holds the global record for household debt for a country with more than 10 million people.

But debt has to continue accelerating for the housing bubble to keep on rising.

America peaked out at around 100 percent of debt to GDP. In Australia we’re already beyond that at 123 percent of GDP. We’ll have to have a house price crash unless Chinese buying is enormous but there is reason to think that Chinese buying is going in the other direction.